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IN THE

SUPREME COURT OF THE UNITED STATES

MARTIN SCHACHTER AND BARBARA SCHACHTER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. Whether the Tax Court in determining a tax deficiency based on gross income rather than net taxable income, by disregarding circumstantial evidence in the form of Internal Revenue Service published source of income statistics, abridges taxpayers' due process rights?

II. Whether a credit may be allowed to offset or reduce the civil fraud penalty in a tax case for a previously paid fine in a criminal tax case imposed under 18 U.S.C. § 3622?

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MARTIN SCHACHTER AND BARBARA SCHACHTER,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Martin and Barbara Schachter respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., infra, 1a–3a)[1] is unreported. The opinions of the Tax Court (App., infra, 4a–22a and 23a–30a) are reported at 76 T.C.M. (CCH) 113, T.C. Memo. 1998-260 (1998), and 113 T.C. 192 (1999).

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[1] Numbers followed by "a" refer to pages in the Appendix.

JURISDICTION

The court of appeals entered its judgment on March 22, 2001 (App., infra, 1a–3a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case involves a provision of the Fifth Amendment to the United States Constitution.

"No person shall be . . . deprived of life, liberty, or property, without due process of law; . . . ." U.S. Const. amend. V.

This case also involves statute provisions under the Internal Revenue Code, 26 U.S.C. §§ 62, 63, 162, and 703 (1988 & Supp. I 2000). The second question presented involves a federal criminal statute, 18 U.S.C. § 3622 (1984) (amended, and currently found in 18 U.S.C. § 3572 (2000).

"26 U.S.C. § 62. ADJUSTED GROSS INCOME DEFINED.

> (a) GENERAL RULE. – For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:
>
> > (1) TRADE AND BUSINESS DEDUCTIONS. -- The deduction allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade of business does not consist of the performance of services by the taxpayer as an employee."

"26 U.S.C. § 63. TAXABLE INCOME DEFINED.

(a) IN GENERAL – Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).

(b) INDIVIDUALS WHO DO NOT ITEMIZE THEIR DEDUCTIONS – In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term "taxable income" means adjusted gross income, minus –

(1) the standard deduction, and

(2) the deduction for personal exemptions provided in section 151."

"26 U.S.C. § 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL – There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including -- . . . ."

"26 U.S.C. § 703, PARTNERSHIP COMPUTATIONS.

(a) INCOME AND DEDUCTIONS. – The taxable income of a partnership shall be computed in the same manner as in the case of an individual . . . ."

* * * *

"18 U.S.C. § 3622: Factors relating to imposition of fines.

(a) In determining whether to impose a fine and the amount of a fine, the court shall consider, in addition to other relevant factors - -

(1) the nature and circumstances of the offense;

(2) the history and characteristics of the defendant;

(3) the defendant's income, earning capacity, and financial resources;

(4) the burden that the fine will impose upon the defendant, any person who is financially dependent on the defendant, or any other person (including a government) that would be responsible for the welfare of any person financially dependent on the defendant, relative to the burden that alternative punishments would impose;

(5) any pecuniary loss inflicted upon others as a result of the offense;

(6) whether restitution is ordered and the amount of such restitution;

(7) the need to deprive the defendant of illegally obtained gains from the offense;

(8) whether the defendant can pass on to consumers or other persons the expense of the fine; and

(9) if the defendant is an organization, the size of the organization and any measure taken by the organization to discipline any officer, director, employee, or agent of the organization responsible for the offense and to prevent a recurrence of such an offense.

(b) If, as a result of a conviction, the defendant has the obligation to make restitution to a victim of the offense, the court shall impose a fine or penalty only to the extent that such fine or penalty will not impair the ability of the defendant to make restitution."

STATEMENT

A. PRELIMINARY BACKGROUND

Petitioners, Martin and Barbara Schachter sued the Commissioner of the Internal Revenue Service by filing a petition with the United States Tax Court. The case involved a re-determination of income tax for the calendar years 1985, 1986, 1987 and 1988, and proposed additions to the tax for civil fraud.

The principal subject of this appeal is the taxable income derived from their partnership, Cal-Ben Company, a small wholesale distributor. Cal-Ben Company is primarily involved in the wholesale distribution of soap products, such as bath soap, laundry detergent, dishwashing liquid and shampoo.

The Tax Court case was consolidated with a case involving Mr. Schachter's other partner in Cal-Ben Company, David Karp. That case, Marcia Karp and the Estate of David Karp, Docket No. 21513-96, was settled prior to the Tax Court trial. Mr. Schachter and Mr. Karp previously had been indicted for tax evasion and conspiracy to defraud the United States. Mr. Karp died soon after the indictment, and Mr. Schachter pled guilty to violations of the aforementioned offenses for the 1986 tax year.

This is an appeal from an Opinion by the Court of Appeals for the Ninth Circuit affirming a Tax Court Opinion and a Tax Court Memorandum Opinion issued by the United States Tax Court after a trial on the merits.

The principal issue was to determine whether there was omitted income from the Cal Ben Co. partnership, as alleged by the respondent Commissioner of Internal Revenue (IRS), and the resulting amount of taxable income. The IRS also alleged additions to the tax due to the civil fraud penalty; therefore, the IRS had to prove this allegation for each separate tax year (1985, 1986, 1987 and 1988), by clear and convincing evidence. If the IRS could not prove that the civil fraud penalty is applicable, then no deficiency could be asserted as the statute of limitations would have expired to assess the tax.[2]

The Court of Appeals for the Ninth Circuit affirmed the Tax Court Opinions for the same reasons stated by the Tax Court. In its Memorandum Opinion, the Tax Court acknowledged that many of the financial records were no longer in existence. Even so, the court disregarded competent evidence of comparable gross and net income statistics published by the IRS, presented by a certified public accountant who was qualified as an expert witness, to prove and corroborate the appropriate net profit margin of the Cal-Ben Co. partnership.

Subsequently, the Tax Court directed the parties to submit computations under Rule 155, United States Tax Court Rules of Practice and Procedure, to resolve the amount of the tax deficiencies and penalties. The parties agreed on the amounts of the deficiencies based on the Memorandum Opinion, but did not agree as to whether a credit for a $250,000 fine paid in the prior criminal case

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[2] The notice of deficiency was issued by the IRS on December 7, 1995, a date more than three years after the tax returns were filed, as well as more than six years after the returns were filed, if the IRS had asserted more than 25% of gross income had been omitted. See 26 U.S.C. § 6501(a) and (e).

was to be allowed to offset or reduce the civil fraud penalty asserted. The parties filed Memoranda of Law on the issue, and the court subsequently issued Tax Court Opinion, 113 T.C. 192 (1999) (App., infra, 23a-30a), denying the credit for the previously paid $250,000 fine.

B. THE CIRCUMSTANTIAL STATISTICAL EVIDENCE OF NET TAXABLE INCOME

This is a tax case, and a circumstantial evidence case. The heartland of this case is that taxable income is the measure, not gross income. Petitioners do not dispute the fact that there are unreported sales. However, unreported sales do not equal taxable income. Taxable income as defined by statute must be determined. 26 U.S.C. §§ 63 and 703.[3] It is fundamental that gross receipts must be reduced by cost of goods sold and other deductible expenses to arrive at taxable income. 26 U.S.C. § 162; *Metra Chem Corp. v. Commissioner*, 88 T.C. 654 (1987); *Franklin v. Commissioner*, 65 T.C.M. (CCH) 2497, 2503 (1993); *T and K Manufacturing, Inc. v. Commissioner*, 52 T.C.M. (CCH) 1259 (1986). From inception, after Mr. Schachter pled guilty to fraud in a criminal case, the IRS was attempting to tax the Schachters not on taxable income, but rather on gross receipts or income, which is not supported by the Internal Revenue Code.[4] To justify its position of disregarding the source of income statistics, the

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[3] Taxable income computations of a partnership are pursuant to 26 U.S.C. §§ 702, 703, 704 and 6031.

[4] The Estate of David Karp settled prior to the Tax Court trial. This settlement was for a considerable discount. The IRS and the court sought to extract an over-proportionate amount of tax from the Schachters because Mr. Schachter had pled guilty to tax evasion. To do so, the IRS seeks to tax the Schachters on gross receipts, a measure not equivalent to taxable income.

Tax Court found the entity form of taxpayers' business is material, rather than the economic substance and volume of the business activity. It is clear that additional sales of soap products have a cost basis inextricably intertwined with each sale. If the Tax Court had acknowledged the economic substance of the business activity, the statistical data relating to the tax years in question, would have had to be considered in order to determine net profit and true taxable income, as required by the Internal Revenue Code.

The Tax Court effectively denied petitioner due process of law by taxing them on their gross income, instead of net taxable income in a manner similarly situated taxpayers are taxed. The error of the Tax Court is to disregard such evidence and essentially buy into respondent's position that unreported gross sales or receipts should be taxed without consideration of net income or taxable income. Basically, the court places these taxpayers in a different category than similarly situated taxpayers, because taxpayer Martin Schachter pleaded guilty to fraud. Thus, the court and respondent essentially argue unreported sales can be taxed as "taxable income." This erroneous result is reached by the Tax Court because it excluded circumstantial statistical evidence relating to net profit or income for similarly situated taxpayers selling similar soap products. The Tax Court and respondent assert erroneously that such evidence is unreliable. Further, respondent maintains such evidence is unrealistic because taxpayers cannot show additional expenses, which begs the heartland question of determining what is taxable income. The essence of this case is what is taxable income. Certainly, circumstantial evidence published by the IRS is competent evidence. The IRS statistical evidence is based on the economic substance of similar entities. Such evidence produces an approximate net profit or taxable income percentage substantially below respondent's tax

computation based upon taxing unreported gross sales or income.

Both parties agree that there are incomplete records for the Cal-Ben Co. business. However, additional expenses were shown at the trial. Consequently, comparable industry data based on similarly situated business activity is reliable evidence to support the fact that there are additional expenses. Otherwise the net profit percentages as determined by the IRS based on gross sales are economically unrealistic and erroneous. Gross sales receipts derived from sales of soap products which have an inherent expense factor associated with each unit sold is not the equivalent of taxable income as contemplated by the Internal Revenue Code, without consideration of the cost factor. The statistical evidence considers the cost factor in determining net profit or taxable income percentages for similarly situated taxpayers.

REASONS FOR GRANTING THE PETITION

I. THE DECISION BELOW ABRIDGES DUE PROCESS RIGHTS BY DETERMINING A TAX BASED ON GROSS INCOME WHILE SIMILARLY SITUATED TAXPAYERS ARE TAXED ON NET TAXABLE INCOME

This case involves a determination by the Tax Court that additional gross income was due by petitioners. The Tax Court infringed petitioners' due process rights by determining a tax that is different than similarly situated taxpayers who are taxed on net taxable income. In order to promote fairness in the administration of taxes and the uniformity of the tax laws, it is necessary for this Court to provide guidance on the measure of taxable income.

Every citizen should know that they have an opportunity to be treated fairly and to compute taxable

income in a tax case. Further, every taxpayer should have the right to determine taxable income. This method of proof is supposed to be allowed through proof by either direct or circumstantial evidence. Petitioners used circumstantial evidence published by respondent Internal Revenue Service (IRS) to determine the net taxable income. Circumstantial source of income and statistical data evidence is relevant and material. *Rubin v. Commissioner*, 13 T.C.M. (CCH) 1094 (1954). It was error for the Tax Court to disregard the evidence of survey and statistical data proffered by petitioners for consideration in its determination of taxable income. The records of petitioners' company, Cal-Ben Co., were incomplete; therefore, industry data is relevant and material to prove taxable income.

The IRS's trial attorney represented to the Tax Court in opening statements of the trial that this was a circumstantial evidence case. However, the court refused to acknowledge the use of statistical and comparative data published by the IRS to establish the profit margin and unreported taxable income of Cal-Ben Co.

A. THE COURT ERRONEOUSLY DISREGARDED THE HISTORICAL AND STATISTICAL DATA PUBLISHED BY THE IRS AND FROM CAL-BEN CO. AND THE SOAP DISTRIBUTING INDUSTRY PRESENTED BY PETITIONERS

The Tax Court completely disregarded the concept of computing taxable income, and instead held to the notion that gross receipts equals taxable income. However, the Tax Court itself long ago determined such analysis equating gross receipts with taxable income is arbitrary. *Rubin v. Commissioner*, 13 T.C.M. (CCH) 1094 (1954).

The tax system requires guidance for the fair administration of the tax laws. This Court in *Cheek v. United States*, 498 U.S. 192 (1991), acknowledged that the tax laws are extremely complex and technical. The Court held that an American Airlines pilot's honest good faith belief of the income tax law, whether or not objectively reasonable, is relevant to the his intent and willfulness in the reporting of taxes. Petitioners request this Court to provide guidance on the form of evidence that shall be considered by the Tax Court in determining taxable income.

It was plain error for the Tax Court to disregard objective evidence in the form of source of income statistics in arriving at its taxable income determination. The Tax Court held that the survey information is derived from companies not comparable to the taxpayers' business. The Tax Court's reason why the survey information is not comparable is because it was obtained from an average of companies which were sole proprietorships, partnerships, and corporations. Such reasoning with respect to the comparability of the statistics is erroneous for two reasons: First, the IRS statistics were in fact separated by entity, and second, the essential factors of comparability are the economic substance of the business, not the form of doing business.

The IRS Source of Income (SOI) Statistics are separated by business entity. The statistics used to compare to Cal-Ben Co. were in fact only partnership statistics. The statistics include the information by partnerships, number of partners, total assets of the partnership, and industry group. Thus, the Tax Court's reasoning was erroneous in its conclusion that there was no credible basis for allowing Cal Ben additional business expenses because the statistics included all business entity forms. The court was only examining the Dun & Bradstreet ratios, which were

comprised of every business entities grouped together. Notwithstanding that the IRS statistics, upon which petitioners rely, are based on the partnership form of doing business, it is the economic substance of the business activity and soap products sold that is realistically determinative of the net profit or taxable income. Taxable income, not gross receipts, is the measure for determining the tax. 26 U.S.C. §§ 63 and 703.

The IRS SOI Bulletin and Statistics, now published on the IRS website at http://www.irs.gov, are to be relied on by the public. The categories are arranged by business entity, i.e., partnership; type of business, i.e., wholesaler; type of product, i.e., soap products; and size of business by asset size or sales volume.

A comparison of the IRS and the private industry statistics reveals that the statistics are comparable and relevant. Whether the statistics are broken down by entity or not, the results are similar. The income and cost factors are comparably the same for a wholesale soap business of the same size. The evidence in the record reveals that the private surveys and statistical data were compiled from the same type and size of businesses. The significant factor is not the form of the company, but the type and size of business. Cal-Ben Co. is a wholesaler of soap products. The selling of soap products by any form of business has associated with it essentially the same cost of acquiring the product for sale, and the expenses attributable to each soap product sale. Cal-Ben Co. buys the products already boxed up with their own packaging and labels from suppliers. The company's cost of goods sold are high, just as with any other wholesaler, because the products arrive in a completely finished state. The evidence in the record shows that both the IRS SOI Statistics and private industry (Robert Morris and Dunn and Bradstreet) statistical data arrived at comparable ratios. The grouping of business

entities in the private industry statistics did not alter the results compared with the IRS statistics based solely on partnership entities. All the statistical evidence was compiled from the same wholesale distribution of chemicals and allied products businesses that were the same size of business as the Cal Ben Co. business. Further, witnesses testified at trial that Cal Ben Co. was not a controlling force in the business; therefore, it could not affect the market. The market place was very competitive and affected Cal Ben Co.'s pricing. It is thus irrelevant whether Cal Ben Co. operated as a partnership, corporation or sole proprietorship.

The court of appeals and the Tax Court rely on *United States v. Marabelles*, 724 F.2d 1374 (9th Cir. 1984), for the position that statistical data deserves little or no weight where the record does not establish that such data is based on similar businesses. In that case, the trial court excluded the defendant's expert and his schedules in a criminal tax case. The proffered expert was a bank loan officer, who was an expert in bank loans, but not in taxation or in the taxpayer's business. Also, the witness had not evaluated Marabelles' business operation or records. The district court explained the statistics were relevant, but the witness was not qualified to explain them.

In the Schachter's case, Certified Public Accountant Brian A. Sullivan was qualified by the Tax Court as an expert, and the statistics used were for the same type of business. The statistics were compiled by both the IRS and private businesses and included wholesale businesses of soap and cleaning products. Therefore, data from the same type of businesses was used to compare to Cal-Ben Co. The case law provides that the lack of substantiation of expenses from available records does not affect the use of statistical data.

The court of appeals also cites *Lollis v. Commissioner*, 595 F.2d 1189 (9th Cir. 1979), where the Court noted that the accountant used tax returns of the business which had not been audited, and did not observe the inventory or confirm the receivables. In the Schachter's Tax Court case, the 1994 and 1995 tax years were audited by the IRS and there were no substantial changes. Further, Brian A. Sullivan, a Certified Public Accountant, exercising his professional expertise, who was familiar with the Cal-Ben Co. business, reviewed all the inventory and records that were in existence. His utilization of the statistical evidence and opinion as to taxable income is based on direct and circumstantial evidence.

It is a well settled principle established by the Tax Court that it is allowable for the parties to rely on statistical data for proof at trial. As long ago as 1942, the IRS has relied on statistical data for proof at trial. In *Oliver v. Commissioner*, 1 T.C.M. (CCH) 8 (1942), the IRS computed the taxable income of an attorney specializing in the trial of negligence and accident cases, from bank deposits and checks drawn against his accounts. Not all of the taxpayers' checks issued in 1936 against the accounts were available during the audit. Consequently, respondent allowed as a deduction from gross income 64.0847%, as a percentage of gross income equal to the average of the ratios of deductions to gross income in the two preceding years.

In *Hong v. Commissioner*, 63 T.C.M. (CCH) 1959 (1992), the Tax Court determined the amount of additional income that taxpayer Kun Kim earned from his Korean massage parlor in Newport Beach, California. The determination of taxable income was arrived at by subtracting from the total gross receipts calculated for each year a flat 40% as operating costs. The IRS made the determination of operating cost percentage in Hong, unlike

petitioners' case where the Tax Court completely disregarded its time tested analysis of determining taxable income for a taxpayer business, where cost of goods sold and expenses are material to determining taxable income, but the records are incomplete.

The Tax Court sustained the IRS's denial of the claimed business deductions for lack of substantiation, in *Rubin v. Commissioner*, 13 T.C.M. (CCH) 1094 (1954), but accepted the testimony of the taxpayer (small grocery store owner) as true. The Court indicated it was unrealistic to determine that the taxpayer incurred no expenses in deriving gross receipts. Accordingly, the Court found as an ultimate fact that the taxpayer's cost of goods sold was at least 75% of gross sales, and 25% of reported gross sales constituted additional net income. See *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930).

Finally, the IRS went so far in one case as to statistically determine income of a family of six people based on what an average family of four earns, multiplied by 145%. *Howarth v. Commissioner*, 42 T.C.M. (CCH) 536 (1981). In that case, the taxpayer was self-employed in the retail sports apparel and trophy business. Records were insufficient to precisely reconstruct income and expenses. The IRS therefore used Bureau of Labor Statistics intermediate budget figures for an urban family with four or more children to arrive at an income amount for the taxpayer's six-person household. Taxpayer's attempt at substantiating business expenses disclosed duplication and triplication of many items. However, since the items supported the incurring of substantial expenses, the Court allowed a deduction for business expenses of 50% of gross receipts.

In the present complex tax world, it is necessary for all taxpayers to be able to utilize reliable statistical data and

other circumstantial evidence to determine taxable income as the lawful measure upon which the income tax is computed. It is for this reason the Supreme Court should decide this issue and this case.

B. PETITIONERS WERE DENIED DUE PROCESS OF LAW AS EVEN THE DIRECT EVIDENCE SUBMITTED AT THE TRIAL WAS ERRONEOUSLY DISREGARDED BY THE TAX COURT

The court of appeals and the Tax Court stated that Cal Ben's reported sales receipts and income for 1994 and 1995 were not indicative of income for earlier years. There is no dispute by the IRS that all sales were reported in 1990-1995. It was established that the average net profit percentage of Cal-Ben Company is usually between 8 to 10 percent during the 1990-1995 tax years.

The IRS examining revenue agent corroborated the direct evidence of Cal-Ben Co.'s position that its average profit percentage was between 8 to 10 percent in the following six years. He testified that at the time of the trial he recently had concluded the audit of the Schachters' 1994 and 1995 tax returns. (The revenue agent was also the examining agent of the 1986, 1987 and 1988 tax returns.)

At the trial, the Schachters proved additional expenses of cost of goods sold which were not reported from the Lloyds bank account. The IRS conceded petitioners were entitled to such expenses in the amount of $19,502.59. Also, the purchase of vehicles was not traceable to business accounts, although the record clearly reveals that such vehicles were used in Cal-Ben's business operations. Various witness testified that these trucks were purchased by the partners, as agents of the partnership, leased to the company, and used in the business. Thus, there is additional evidence, direct and circumstantial to

support the statistical data relating to determining the taxable income based on the fact expenses were incurred, some of which could be proven by direct evidence and the remainder by circumstantial evidence.

The IRS's own published data contained in the statistical circumstantial evidence supported the direct evidence pertaining to the results of revenue agent's examination of the 1994 and 1995 tax years. This evidence is relevant to establishing that it is arbitrary to have a net income percentage of 19%-34% in any year. This evidence also confirms that the economically realistic net profit percentage is in the single digit percentile. The circumstantial evidence of the IRS Source book corroborated the revenue agent's testimony as the statistics indicate a net profit or taxable income ratio of between 4.78% to 6.30%. Notwithstanding, the Tax Court allowed the IRS to disavow its own source of information, and instead impose an unreasonable double digit 19-34% range, based on gross receipts calculations.

In order to promote fairness under the complex income tax laws, so that every citizen can rely on the rule of law, it is necessary for this Court to clearly establish that taxable income, not gross income, is the measure in a tax case, and this measure can be proven by both direct and circumstantial evidence.

II. THE DECISION BELOW IS ONE OF FIRST IMPRESSION AND AFFECTS ALL PERSONS WHO PAY A FINE IN A CRIMINAL CASE AND THEREAFTER PAY A CIVIL FRAUD PENALTY IN A CIVIL CASE

The issue is whether a credit may be allowed to offset or reduce the civil fraud penalty in a tax case for a previously paid fine in a criminal tax case imposed under 18 U.S.C. § 3622. Specifically, in this case petitioners

maintain they are entitled to a credit or offset to the civil fraud penalty for the $250,000 amount previously paid to the United States as a criminal fine.[5]

Petitioner Martin Schachter pled guilty to tax evasion and conspiracy to defraud the United States in violation of 26 U.S.C. Section 7201 and 18 U.S.C. Section 371. The sentence was two years in prison, and five years probation. Further, the court ordered a fine in the amount of $250,000, restitution in the amount of $161,845, and a special assessment in the amount of $100.

The Tax Court's Opinion, as affirmed by the Court of Appeals for the Ninth Circuit, determined the Schachters are liable for deficiencies in tax, and additions to the tax, including the civil fraud penalty totaling in excess of $1,500,000.[6]

First, the label itself is not determinative of the nature or reason for a fine, penalty or restitution. The legal definitions for fines and penalties are interwoven.

The definition of a fine is: ". . . 5. A pecuniary criminal punishment or civil penalty payable to the public treasury. . . ." BLACK'S LAW DICTIONARY 646 (7th ed. 1999).

The definition of a penalty, as in civil fraud penalty, is: "1. Punishment imposed on a wrongdoer, esp. in the form of imprisonment or fine. * Through usu. for crimes,

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[5] This issue was one of first impression in the Tax Court. The issue is different than the double jeopardy question which has been decided by the Supreme Court in *Helvering v. Mitchell*, 303 U.S. 391 (1938); *Hudson v. United States*, 522 U.S. 93 (1996).

[6] Petitioners have already paid in excess of $1,100,000 into the United States Treasury towards the civil liability.

penalties are also sometimes imposed for civil wrongs. . . ." BLACK'S LAW DICTIONARY 1153 (7th ed. 1999).

The issue is whether a credit may be received for the payment of the previously paid fine against the determined civil fraud penalty. The IRS gave the Schachters a credit towards the civil tax deficiency, for the $161,845 restitution amount previously imposed and paid in the criminal case.

The fact, by itself, that a fine was ordered in the criminal case does not make it solely punitive. Alternatively, the civil fraud penalty may have a deterrent effect, but the Supreme Court has stated that it is remedial. The Supreme Court recognized that monetary penalties or fines may deter others without being criminal in nature. *Hudson v. United States*, 522 U.S. 93 (1997). In other words, the Supreme Court has stated that the mere presence of this deterrent effect purpose is insufficient to render a sanction punitive. Additions to tax for fraud do not amount to an affirmative disability or restraint, nor have they historically been regarded as punishment. See *Hudson*, 522 U.S. at 104. The purpose of additions to tax for fraud is remedial; they "are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud." *Helvering v. Mitchell*, 303 U.S. 391, 401 (1938).

The IRS maintains that the fine imposed by the district court was strictly for the purpose of punishment. However, a thorough examination of the factors, reveals a remedy that is aimed at numerous criteria. The factors are aimed more at raising revenue, and not impairing the person's ability to pay, rather than being a deterrent or retribution.

In determining whether to impose a fine pursuant to 18 U.S.C. § 3623, the court examines the factors set forth in 18 U.S.C. § 3622.

(a) (1) the nature and circumstances of the offense;

(2) the history and characteristics of the defendant;

(3) the defendant's income, earning capacity, and financial resources;

(4) the burden that the fine will impose upon the defendant, any person who is financially dependent on the defendant, or any other person (including a government) that would be responsible for the welfare of any person financially dependent on the defendant, relative to the burden that alternative punishments would impose;

(5) any pecuniary loss inflicted upon others as a result of the offense;

(6) whether restitution is ordered and the amount of such restitution;

(7) the need to deprive the defendant of illegally obtained gains from the offense;

(8) whether the defendant can pass on to consumers or other persons the expense of the fine; and

****

The statute also provides that if restitution is ordered, then "*the court shall impose a fine or penalty only to the extent that it will not impair the ability of the defendant to make restitution.*" 18 U.S.C. § 3622(b). (emphasis added).

The plain language of the factors relating to imposition of a fine reveal a remedy that is more aimed at

raising revenue for the government than deterring the defendant. In fact, some of the factors listed, i.e., considering the person's income, earning capacity, and financial resources, are specifically included so as not to have an overly negative impact on the individual.

The principal punishment in Mr. Schachter's criminal case was incarceration. Remedial or revenue raising factors form much of the basis for imposition of the fine. Therefore, the Schachters claim they are entitled to a credit towards the payment of any civil fraud penalty to be paid to the United States Treasury, for the $250,000 fine previously paid to the United States, in order to fully be able, rather than impair their ability, to make restitution.

The factors that are involved in both imposition of the civil fraud penalty and the criminal fine are similar in nature, both being remedial, penal in a monetary or pecuniary sense, and also being restitution. It follows from the above discussion that the Schachters should be entitled to a credit or offset reducing the amount to be paid of any sustainable civil fraud penalty, for the $250,000 criminal fine previously paid into the United States Treasury.

The Supreme Court should accept this issue and this case to set out guidelines in interpreting the application of the statutory factors in circumstances where both criminal and civil penalties are imposed for the same conduct or transaction, and the United States Treasury is both the victim and beneficiary.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

NOT FOR PUBLICATION
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FILED
MAR 22 2001
CATHY A CATTERSON
CLERK, U.S. COURT OF
APPEALS

MARTIN SCHACHTER;
BARBARA SCHACHTER,

Petitioner,

v.

COMMISSIONER OF
INTERNAL REVENUE,

Respondent.

No. 99-71436

Tax Ct. No. 2939-96

MEMORANDUM[1]

Appeal from a Decision of the
United States Tax Court

Argued and Submitted February 14, 2001
San Francisco, California

Before: HUG, NOONAN, and W. FLETCHER, Circuit Judges.

Martin and Barbara Schachter (Schachters) appeal from an order of the tax court. The Schachters argue that the tax court erred in disregarding additional expenses that the IRS should have considered in measuring their company's taxable income.

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1 This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as may be provided by 9th Cir. R. 36-3.

The Schachters also contend that the tax court erred in determining they were not allowed a credit or offset for the civil penalty imposed by the tax court because of a previously paid criminal fine. We have jurisdiction to hear final orders from the tax court pursuant to 26 U.S.C. § 7482, and we affirm the tax court's decision. The parties are familiar with the factual and procedural history of the case; therefore, we will not recount it here.

We review the tax court's factual findings underlying its decision to deny additional business expenses under the clearly erroneous standard. Norgaard v. Commissioner, 939 F.2d 874, 877 (9th Cir. 1991). Whether the Schachters are entitled to a credit or offset for the civil penalty due to a previously imposed criminal penalty is a question of law reviewable de novo. *Baker v. Commissioner*, 204 F.3d 1231, 1233 (9th Cir. 2000).

The Schachters argue that the tax court erroneously equated gross receipts with taxable income when it disallowed additional business expenses in determining taxable income. However, the court allowed reported deductions on the income returns for 1985-1988, and allowed additional expenses for consulting fees and truck depreciation. Moreover, the IRS had established the Schachters had unreported income; therefore, there was a presumption that deductions and exclusions listed by the taxpayer in his return are all that existed. *United States v. Bender*, 218 F.2d 869, 871(9th Cir. 1955).

The Schachters could not produce direct evidence showing additional expenses because of their inadequate books and records. The Schachters had a duty, however, to maintain sufficient records in order to establish deductions. See 26 U.S.C. § 6001. Because direct evidence was lacking, the Schachters; provided testimony regarding additional expenses. The question of whether a taxpayer is allowed expenses is a question of fact

established by the taxpayer's evidence, the credibility of the taxpayer, and the credibility of supporting witnesses. Norgaard, 939 F.2d at 878. The tax court determines the credibility of the proffered testimony. *McKay v. Commissioner*, 886 F.2d 1237, 1238 (9th Cir. 1989). The tax court found that the proffered evidence was not credible. Based on a review of the record, we agree for the same reasons given by the tax court.

The Schachters also argue they are entitled to a credit or offset for the civil penalty because the civil fine and the earlier criminal fine are both remedial in nature. We disagree. The criminal penalty assessed to Martin Schachter (under 18 U.S.C. §§ 3622 and 3623) for tax evasion and conspiracy to defraud the United States was directed towards punishment. The legislative history of §§ 3622 and 3623 is clear in explaining that the purpose for the criminal penalty is punishment. The factors to be considered in determining a penalty under § 3622, including the consideration of the person's income, earning capacity, and financial resources, are to help ensure that "realistic fines are more likely to be collected," and that "greater equity in punishment will be fostered." H.R. Rep. No. 98-906, at I (1984), reprinted in 1984 U.S.C.C.A.N. 5433, 5435. Moreover, allowing the Schachters a credit for the criminal fine already paid is inconsistent with the idea that tax fraud is subject to both criminal and civil sanctions. *Louis v. Commissioner*, 170 F.3d 1232, 1235 (9th Cir. 1999).

AFFIRMED.

APPENDIX B

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MARTIN A.
SCHAINBAUM
A.P.L.C.

T.C. Memo. 1998-260

UNITED STATES TAX COURT

MARTIN AND BARBARA SCHACHTER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2939-96. Filed July 15, 1998.

Martin A. Schainbaum, for petitioners.
Paul J. Krug, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, Judge: Respondent determined deficiencies in and additions to tax with regard to petitioners, taxable years as follows:

Year	Deficiency	Additions to Tax							
		Sec. 6653 (a)(1)	Sec. 6653 (a)(1)(A)	Sec. 6653 (a)(1)(B)	Sec. 6653 (b)(1)	Sec. 6653 (b)(1)(A)	Sec. 6653 (b)(1)(B)	Sec. 6653 (b)(2)	Sec. 6661
1985	$163,048	–	–	–	$81,524	–	–	**	$40,762
1986	168,368	–	$ 336	*	–	$121,229	**	–	42,092
1987	154,962	–	2,220	*	–	82,915	**	–	38,741
1988	21,488	$39	–	–	15,525	–	–	–	5,372

* 50 percent of interest due on portion of underpayment attributable to negligence.

** 50 percent of interest due on portion of underpayment attributable to fraud.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

The primary issues for decision are whether petitioners are to be charged with additional partnership income and whether petitioners are liable for the fraud and other additions to tax.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

Petitioners are husband and wife and resided in Hayward, California, at the time they filed their petition in this case. Hereinafter references to petitioner are to Martin Schachter.

In 1954, petitioner's father Ben Schachter began operating as a sole proprietorship a wholesale soap distribution business under the name of Cal Ben Co. (Cal Ben). 11

By May of 1955, petitioner and a relative by the name of David Karp were working as partners in the business, and Cal Ben was conducted as a partnership.

On September 7, 1959, Ben Schacter, David Karp, and petitioner entered into a written partnershili'agreement that provided that they would share equally as partners in the profits and losses of Cal Ben.

On May 1, 1967, Ben Schachter retired and relinquished his interest in Cal Ben. Thereafter, petitioner and David Karp operated Cal Ben as equal partners, and each was entitled to 50 percent of the profits and losses of Cal Ben.

A checking account and a money market account for Cal Ben were maintained in Cal Ben's name at Bay Bank of Commerce. The address for the accounts at Bay Bank of Commerce apparently reflected Cal Ben's mailing address, and all bank statements for these accounts apparently were mailed to Cal Ben's business mailing address.

Also, after August 8, 1977, and during the years in issue, a bank account was maintained at Lloyds Bank California (which in 1986 was acquired by Sanwa Bank California) in the name of 11C B Co., MFG." (the Lloyds/Sanwa account). Petitioner and David Karp were authorized signatories on the Lloyds/Sanwa account. The address for the Lloyds/Sanwa account reflected petitioners' residence address, and all bank statements for the Lloyds/Sanwa account were mailed to petitioners' residence.

Cal Ben's.books and records were maintained and Cal Ben's partnership tax returns were filed using a hybrid method of accounting under which the accrual method of accounting was used to account for purchases and sales of Cal Ben's inventory of soap products, and the cash method of accounting was used to

account for other miscellaneous items of income and for Cal Ben's general business expenses. Cal Ben's general business expenses were recorded on a cash basis in a cash disbursements journal.

From 1955 through 1987, petitioner Barbara Schachter and Marcia Karp, David Karp's wife, maintained on a part-time basis the books and records of Cal Ben. In January of 1987, a fulltime bookkeeper was hired and assumed bookkeeping responsibilities for Cal Ben.

Purchase orders from Cal Ben's customers for soap products generally were received in the offices of Cal Ben over the telephone. Whoever received the telephone purchase orders prepared for each order a sales invoice. A copy of each sales invoice was sent to Cal Ben's warehouse to have the order filled. A copy of each sales invoice was sent to the customers along with the merchandise, and the original of each sales invoice was given to petitioner.

After reviewing sales invoices, petitioner generally would forward the invoices to Cal Ben's bookkeepers. Upon receipt of sales invoices from petitioner, the bookkeepers recorded information relating to the sales reflected by the invoices in Cal Ben's sales journal (reported sales).

During at least 1985, 1986, 1987, and 1988, however, petitioner did not forward to Cal Ben's bookkeepers all of Cal Ben's sales invoices. As a result, sales associated with invoices not forwarded to Cal Ben's bookkeepers were not reflected as sales in Cal Ben's sales journal (unreported sales).

Cal Ben's sales invoices were not identified by number, and therefore unreported sales could not be easily detected and identified.

Petitioner generally opened mail containing payments received from Cal Ben's customers. Payments received relating to reported sales were deposited into Cal Ben's bank accounts at Bay Bank of Commerce. With regard, however, to payments received relating to unreported sales, petitioner or David Karp would prepare bank deposit slips and would deposit the payments into the Lloyds/Sanwa account.

Petitioners were aware of the existence of the Lloyds/Sanwa account, and they were aware that unreported sales were not recorded in Cal Ben's sales journal.

During 1985 through 1988, payments received on sales of Cal Ben's soap products were deposited into the above three bank accounts in the following amounts:

Bank	1985	1986	1987	1988
Bay Bank of Commerce				
Checking acct	$1,525,661	$1,622,475	$1,437,782	$1,711,269
Money Market	-0-	-0-	-0-	204,056
Lloyds/Sanwa acct	683,161	764,642	632,943	145,305
Total Deposits	$2,208,822	$2,387,117	$2,070,725	$2,060,630

Some funds deposited into the Lloyds/Sanwa account were later transferred to Cal Ben's accounts at Bay Bank of Commerce and were used to purchase inventory and other supplies for Cal Ben. Those purchases were recorded in Cal Ben's books and records as purchases.

During the years in issue, petitioners used funds deposited into the Lloyds/Sanwa account to purchase tax-exempt bearer bonds in their individual names. During the years in issue,

petitioners also used funds deposited into the Lloyds/Sanwa account to pay expenses relating to a personal yacht, a facelift for Barbara Schachter, and carpet and utility expenses for petitioners, residence.

Petitioners knew that funds relating to unreported sales deposited into the Lloyds/Sanwa account had been used to purchase the bonds, and Barbara Schachter generally cashed interest coupons associated with the bearer bonds.

In December of 1987, petitioner purchased a 1988 BMW 750IL automobile with cash totaling $72,451.

Cal Ben's 1985 through 1988 Forms 1OG5, U.S. Partnership Return of Income, were prepared by Burton Propp (Propp), a certified public accountant. The gross receipts figures reported by Propp on Cal.Ben's partnership tax returns were taken from reported sales recorded in Cal Ben's sales journal.

Propp was given no information relating to Cal Ben's unreported sales, nor was he given any information relating to payments received from customers that were deposited into the Lloyds/Sanwa account. Propp was not told nor otherwise informed of the existence of the Lloyds/Sanwa account. As a result, total sales receipts of Cal Ben and the taxable income of petitioners relating to petitioner's 50-percent partnership interest in Cal Ben were underreported on Cal Ben's partnership and on petitioners' individual Federal income tax returns

Petitioner understood that he was legally obligated to pay income taxes on his share of Cal Ben's net partnership profits. The schedule below sets forth Cal Ben's gross sales as reported on Cal Ben's partnership tax returns for the years at issue, unreported sales as stipulated by the parties, and Cal Ben's corrected gross sales:

9a

Cal Ben's Gross Sales

Year	Reported	Unreported	Corrected
1985	$1,486,450	$667,862	$2,154,312
1986	1,562,228	660,536	2,222,764
1987	1,455,416	507,766	1,963,182
1988	1,679,209	116,784	1,795,993
Total	$6,183,303	$1,952,948	$8,136,251

On June 6, 1988, 6 days after respondent's representative first contacted petitioner to initiate the audit of petitioners' Federal income tax returns and of Cal Ben's partnership tax returns for 1985 through 1988, petitioner closed the Lloyds/Sànwa account.

On October 24, 1986, petitioner signed an application for a credit card on which he represented that Cal Ben had gross sales for 1985 of $2.1 million.

On Cal Ben's 1986, 1987, and 1988 partnership tax returns, costs for various personal items and for items that, during respondent's audit, petitioners could not substantiate were claimed as deductions.

On petitioners' 1985 through 1988 joint Federal income tax returns, petitioners underreported petitioner's share of the net income of Cal Ben, as follows:

Year	Amount
1985	$333,931
1986	337,606
1987	257,871
1988	79,799

On their 1987 joint Federal income tax return, petitioners underreported gain realized on sale of petitioners, residence located in Aptos, California. The gain was underreported as a result of petitioners' inclusion of nondeductible repair expenses and recurring items in the calculation of their adjusted tax basis in the residence and of petitioners' failure to adjust the tax basis of the residence by casualty losses sustained and claimed in prior years.

During respondent's audit, when petitioner was asked if he had made any purchase with cash in excess of $10,000, petitioner incorrectly stated that he had not done so.

On August 17, 1988, respondent's representative requested petitioner to provide copies of all bank statements for 1985 through 1988 rQlating to Cal Ben and to petitioner. In response to that request, respondent's representative was provided documents pertaining only to the two bank accounts at Bay Bank of Commerce. Respondent's representative was not informed by petitioner of the Lloyds/Sanwa account.

When he discovered deposits into the Lloyds/Sanwa account, respondent's representative requested of petitioner records pertaining to that account, but petitioner refused to provide any further information.

At the conclusion of respondent's audit, respondent determined against petitioners the income tax deficiencies, the fraud, and the negligence additions to tax set forth above, and respondent determined that the fraud related only to unreported sales of Cal Ben and that negligence related to all other adjustments.

In determining the income tax deficiencies, respondent allowed as business expense deductions nearly all of the costs

and expenses that were recorded in Cal Ben's books and records and that were claimed on Cal Ben's partnership tax returns. During and after trial, the parties settled all issues relating to deductions disallowed in respondent's notice of deficiency.

In 1993, a Federal grand jury returned an indictment charging petitioner and David Karp with tax evasion in violation of section 7201.and with conspiracy to defraud the United States by obstructing the lawful ascertainment and collection of income taxes in violation of 18 U.S.C. section 371.

On May 30, 1993, after his indictment, David Karp died.

On September 23, 1993, petitioner pled guilty to one count of tax evasion with respect to his individual income tax liability for 1986 in violation of section 7201 and to one count of conspiracy to defraud the United, States in violation of 18 U.S.C. section 371. In connection with the above plea, petitioner was sentenced to prison and fined $250,000.

OPINION

Under section 6653(b) the addition to tax for fraud is applicable if any part of an underpayment of tax is attributable to fraud. To establish fraud, respondent is required to prove that the taxpayer underreported his or her correct tax liability and that some part of the underreporting was due to fraudulent intent. DiLeo v. Commissioner, 96 T.C. 858, 873 (1991), affd. 959 F.2d 16 (2d Cir. 1992).

Respondent has the burden of proving fraud by clear and convincing evidence. Sec. 7454(a); Rule 142(b); *Bagby v. Commissioner,* 102 T.C. 596, 607 (1994).

As we have found, the evidence establishes that Cal Ben's sales were significantly underreported for each year at issue and that as a result petitioner's share of Cal Ben's sales income was underreported on petitioners, joint Federal income tax returns.

Petitioners contend, however, that Cal Ben's unreported sales for each year should be offset by additional deductible business expenses of Cal Ben that allegedly were paid out of the Lloyds/Sanwa account, that were not properly recorded as expenses in Cal Ben's cash disbursements journal, and that were not claimed on Cal Ben's partnership tax returns. Petitioners contend that the additional expenses, if allowed, would greatly reduce the unreported net income of Cal Ben and the unreported taxable income of Cal Ben chargeable to petitioner. In support of the claimed additional business expenses, petitioners offer evidence of net profit margins of other wholebale businesses. Petitioners note that without allowance of the claimed additional business expenses, net profit margins of Cal Ben would far exceed average net profit margins relating to wholesale businesses, as set forth in government and business survey data. Further, petitioners claim that funds used to purchase bonds, a yacht, and other expensive items for personal use constituted accumulated savings of capital from prior years, not unreported current-year sales of Cal Ben.

Petitioners' arguments are not persuasive.

We first note that the unreported sales of Cal Ben for each of the years in issue reflect figures substantially higher than the claimed additional business expenses of Cal Ben. Thus, even if the claimed additional business expenses of Cal Ben were allowed, the net profits of Cal Ben (and petitioners, underreported taxable income relating thereto) would still be substantial.

Evidence as to average profit margins of other businesses does not overcome, in this case, the evidence that establishes Cal Ben's unreported sales and the lack of any credible evidence that establishes Cal Ben's entitlement to additional business expenses. General survey information regarding other businesses does not, in this case, provide a credible basis for allowing Cal Ben additional business expenses. The survey information is general. It does not purport to represent information on companies comparable to Cal Ben. It raises no doubt in our mind as to the underreporting of significant sales and partnership income that occurred on Cal Ben's partnership tax returns and the underreporting of petitioner's income that occurred on petitioners' Federal income tax returns.

Petitioners argue that Cal Ben's net profit percentages as reflected on Cal Ben's filed and audited partnership tax returns for later years (namely, 1994 and 1995) corroborate their claim that during the years in issue Cal Ben's actual profit margins, were much lower than those reflected by respondent's audit adjustments and that Cal Ben must have incurred and should now be allowed significant additional business expenses during the years in issue. We disagree.

During 1994 and 1995, Cal Ben was operated not as a partnership but as a sole proprietorship owned by petitioner, and Cal Ben was managed by others while petitioner was incarcerated in Federal prison on his sentence for tax evasion and conspiracy. Further, petitioner and Cal Ben incurred extraordinary legal fees in 1994 relating to petitioner's legal problems. Thus, Cal Ben's reported sales receipts and income for 1994 and 1995 are not indicative of Cal Ben's income in earlier years.

In light of the evidence in this case regarding, among other things, Cal Ben's unreported sales, Cal Ben's inadequate

books and records, the undisclosed Lloyds/Sanwa bank account in which payments from unreported sales were deposited, the personal purchases, and petitioner's lack of cooperation, petitioners, attempted use of general survey data regardi'n'g profit margins of unrelated companies is of little persuasive value and is rejected. Although used in appropriate cases -- particularly by respondent where taxpayers have not filed income tax returns and have not maintained adequate books and records -- general survey data may be rejected where taxpayers, as in the instant case, seek to use such data to overcome clear evidence of unreported income. See, e.g., United States v. Marabelles, 724 F.2d 1374, 1381-1382 (9th Cir. 1984); Lollis v. Commissioner, 595 F.2d 1189, 1190-1191 (9th Cir. 1979), affg. T.C. Memo. 1976-15; Cebollero v. Commissioner, 967 F.2d 986 (4th Cir. 1992), affg. T.C. Memo. 1990-618. As we have stated --

> Such evidence is * * * of little probative value and * * * too speculative to serve as the basis for additional reductions in gross income [Farrow v. Commissioner, T.C. Memo. 1985-518.1

We note that once respondent has established unreported sales, the taxpayer has the burden of proving with credible evidence expenses that would offset the unreported sales. See United States v. Marabelles, supra at 1379; Barragan v. Commissioner, 69 F.3d 543 (9th Cir. 1995) (citing Elwert v United States, 231 F.2d 928, 933 (9th Cir. 1956)), affg. without published opinion T.C. Memo. 1993-92; Avery v. Commissioner, T.C. Memo. 1993-344.

For the first time at trial, petitioners asserted their entitlement to additional deductible business expenses for Cal Ben. The petition filed by petitioners made no allegation with regard to unclaimed partnership expenses, and general and vague references in the petition to "additional" facts do not satisfy the

affirmative pleading requirement of Rule 34(b) with regard to such expenses. Pebley v. Commissioner, T.C. Memo. 1981-701, affd. without published opinion 703 F.2d 576 (9th Cir. 1983). Even if petitioners were to conform the pleadings to the proof, the evidence introduced by petitioners at trial regarding alleged additional business expenses was so unsubstantial that such a motion, if made, would be denied. Goldsmith v. Commissioner, 31 T.C. 56, 63-64 (1958).

In any event, with exception of two items that the parties have agreed to, we reject the evidence regarding claimed additional business expenses of Cal Ben.[1] Petitioner's selfserving testimony that Cal Ben's payments from unreported sales deposited into the Lloyds/Sanwa account were used for additional off-the-book partnership expenses was not credible. Copies of checks drawn on the Lloyds/Sanwa account indicate that much of the sales receipts deposited into the Lloyds/Sanwa account was used to make personal investments and to pay personal expenses. other checks were merely made payable to petitioner Barbara Schachter or to David Karp personally. The names of the payees on many of the checks are illegible.

Petitioners did not call as trial witnesses any of the individual payees whose names on the checks are legible to testify as to the purposes of the payments, nor did petitioners introduce any invoices or other records to establish a business purpose for the payments.

---

1. At trial, respondent did allow petitioner additional deductible business expenses for consulting payments of $19,502.59 and for truck depreciation.

The expert report prepared by petitioners' expert for purposes of this litigation is based largely on out-of-court statements purportedly made by petitioner regarding checks written on the Lloyds/Sanwa account. Other than petitioner's testimony, no trial testimony or other documentary evidence was offered or admitted at trial to establish the purpose of the checks.

Although we allowed petitioners, expert's report into evidence, much of the information relied upon by petitioners, expert is vague and so speculative as to make his report largely meaningless. Soden v. Freightliner Corp., 714 F.2d 498, 500-507 (5th Cir. 1983); United States v. Sims, 514 F.2d 147, 149-150 (9th Cir. 1975); Viterbo v. Dow Chem. Co., 646 F. Supp. 1420, 1424 (E.D. Tex. 1986), affd. 826 F.2d 420 (5th Cir. 1987). Further, under rule 703 of the Federal Rules of Evidence, petitioners' expert's reliance on hearsay in his report does not elevate the hearsay to the status of evidence that would establish the truth of the matter asserted (namely, the business nature and deductibility of alleged expenses mentioned therein). Paddack v. Dave Christensen, Inc., 745 F.2d 1254, 1261-1262 (9th Cir. 1984); Greenberg v. United States, 295 F.2d 903, 907-909 (1st Cir. 1961).

Also, because petitioners' expert's report was based, in large part, on hearsay evidence, and not on complete and legible books and records of Cal Ben or of petitioners, the report is not entitled to additional weight under rule 1006 of the Federal Rules of Evidence as a summary of otherwise admissible voluminous records.

Petitioner testified that $50,455 in 1985 and $84,078 in 1987 of payments from unreported sales deposited into the Lloyds/Sanwa account were used to purchase inventory and should be treated as additional cost of goods sold. It appears,

however, that these claimed additional inventory purchases were already taken into account as costs of goods sold in Cal Ben's purchase journal and partnership tax returns.

With regard to illegible checks drawn on the Lloyds/Sanwa account and expenses allegedly incurred for business travel, entertainment, and gifts, the canceled checks and petitioner's unsupported testimony fail the substantiation requirements of section 274 (d) .

The record in this case provides no basis, under Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), for estimating alleged additional business expenses of Cal Ben. Other than expenses the parties have agreed to, no credible evidence supports . petitioners, claim that additional business expenses were incurred by Cal Ben, and no credible evidentiary basis was provided on which estimates of additional business expenses could be made.

Petitioners' claim that the large personal investments and purchases were made with accumulated, nontaxable capital savings from earlier years is completely unsubstantiated and incredible. Petitioners' investments in the bearer bonds and other large personal expenses that were incurred during the years in issue appear clearly to have been paid with payments from unreported sales of Cal Ben deposited into the Lloyds/Sanwa account.

Instead of presenting credible evidence (e.g., receipts, invoices, and testimony of payees identified on checks representing alleged additional business expenses), petitioners largely offered only speculative testimony and general survey data.

The credible evidence before us establishes that petitioner's 50-percent share of the cumulative unreported gross sales of Cal Ben is approximately $960,000. See chart suipra p. 7. It is established that substantial underpayments of petitioners' correct Federal income tax liabilities occurred for each year in issue.

Because of his criminal conviction for tax evasion, petitioner's fraudulent intent with regard to his 1986 Federal income tax liability is established. DiLeo v. Commissioner, 96 T.C. at 885-886; Amos v. Commissioner, 43 T.C. 50 (1964), affd. 360 F.2d 358 (4th Cir. 1965).

With regard to 1985, 1987, and 1988, petitioner's conspiracy conviction constitutes evidence of petitioner's fraudulent intent. Mobley v. Commissioner, 33 F.3d 1382 (11th Cir. 1994), affg. without published opinion T.C. Memo. 1993-60.

The cumulative evidence in this case is strong and persuasive to the effect that, during at least the 4 years in issue, sales of Cal Ben were knowingly underreported, and petitioners' taxable income relating thereto was knowingly and willfully underreported on petitioners' Federal income tax returns.

Petitioner handled the invoices, payments, and bank deposits relating to Cal Ben's unreported sales. Petitioners used payments from unreported sales of Cal Ben to make personal investments and to pay personal expenses.

The evidence is clear and convincing that during 1985 through 1988 petitioner intentionally diverted approximately $2 million of unreported sales of Cal Ben into the Lloyds/Sanwa account. Petitioner intentionally withheld invoices pertaining to these sales from Cal Ben's bookkeepers so that the specific sales

would not be recorded in Cal Ben's sales journal and in the form of partnership income on petitioners, income tax returns.

Barbara Schachter was a bookkeeper for Cal Ben and knew of the Lloyds/Sanwa account and knew generally that payments from unreported sales were deposited into that account were not recorded in Cal Ben's sales journal. Barbara Schachter's claim that she understood that many of the checks deposited into the Lloyds/Sanwa account represented bad checks is not credible. Bank statements for the Lloyds/Sanwa account were mailed to petitioners, residence, and Barbara Schachter was the recipient of significant funds paid out of that account.

The evidence is persuasive, and we so find, that petitioners each fraudulently intended to evade reporting and paying their correct Federal income tax liabilities for 1985, 1986, 1987, and 1988 relating to unreported sales of Cal Ben. Petitioners underreported their distributive share of Cal Ben's income with knowledge of the understatements and with intent to commit fraud.

Further evidence of petitioners, fraud includes: (1) The large discrepancies between the income reported on petitioners' income tax returns and petitioners' corrected income; (2) the failure to maintain accurate and complete books and records; (3) the fact that petitioners provided incorrect and incomplete information to their tax return preparer; and (4) the fact that petitioners did not disclose the Lloyds/Sanwa account to respondent's representative.

Lastly, with regard to fraud, petitioners argue that imposition of the civil fraud addition to tax on top of petitioner's prison sentence and fine relating to his-criminal conviction would constitute double jeopardy and would violate the U.S. Constitution.

We disagree. See Hudson v. United States, 522 U.S. 118 S. Ct. 488 (1997); Kennedy v. Mendoza-Martinez, 372 U.S. 144 (1963); Helvering v. Mitchell, 303 U.S. 391 (1938); Grimes v. Commissioner, 82 F.3d 286 (9th Cir. 1996); and I & 0 Publg. Co. v. Commissioner, 131 F.3d 1314 (9th Cir. 1997), affg. Ward v. Commissioner, T.C. Memo. 1995-286, which are controlling on this issue in favor.of respondent.

Because a part of petitioners' underpayment of tax for each year in issue was due to fraud, the assessment of tax deficiencies for each year is not barred by the statute of limitations. Sec. 6501(c)(1); Meier v. Commissioner, 91 T.C. 273, 303 (1988).

Respondent determined that the negligence addition to tax under section 6653(a) applies to the portion of the deficiencies in tax for 1986, 1987, and 1988 that are not subject to the fraud addition to tax (namely, the entire amount of the deficiencies other than that portion attributable to petitioner's share of Cal Ben's unreported sales). The portions of the deficiencies against which the negligence additions to tax were determined relate primarily to unsubstantiated claimed partnership business expenses and the inclusion of repairs in petitioners' calculation of the tax basis on the Aptos residence, issues which the parties have settled.

The negligence addition to tax will apply if, among other things, the taxpayer fails to maintain adequate books and records with regard to the items in question. Crocker v. Commissioner, 92 T.C. 899, 917 (1989). Because of petitioners' failure to maintain such records and because of petitioners' improper calculation, without adequate explanation, of the tax basis of the Aptos residence, we conclude that petitioners are liable for the negligence additions to tax relating to the above items and to all other adjustments in issue.

Section 6661(a) provides an addition to tax of 25 percent[2] of the amount of any underpayment attributable to a substantial understatement of tax. The term "understatement" is defined in section 6661(b)(2)(A) as being the excess of the amount of tax required to be shown on the return for a year over and above the amount shown on the return. An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. The amount of the understatement can be reduced if substantial authority exists for the taxpayer's treatment of the item in dispute, or if the item is adequately disclosed in the return or in a statement attached to the return. Sec. 6661(b)(2)(B). For each year involved in this case, the deficiencies exceed both 10 percent of the tax required to be shown on the return and $5,000.

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2 In their trial memorandum, petitioners state that a 10percent rate was in effect for 1985. However, sec. 8002 of the Omnibus Budget Reconciliation Act of 1986, Pub. L. 99-509, 100 Stat. 1951, increased the rate to 25 percent for penalties assessed after Oct. 21, 1986. Therefore, the correct rate for 1985 is 25 percent. Licari v. Commissioner, 946 F.2d 690 (9th Cir. 1991), affg. T.C. Memo. 1990-4.

Petitioners presented no credible evidence that there existed substantial authority for the erroneous treatment of any item on their income tax returns or that any item was adequately disclosed on their tax returns. Petitioners are liable for the substantial understatement additions to tax pursuant to section 6661. See Slater v. Commissioner, T.C. Memo. 1996-366; Miravalle v. Commissioner, T.C. Memo. 1994-49.

Decision will be entered under Rule 155.

APPENDIX C

113 T.C. No. 14

UNITED STATES TAX COURT

MARTIN AND BARBARA SCHACHTER, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent*

Docket No. 2939-96. Filed September 14, 1999.

Held: No credit is allowed against civil fraud additions to tax for a criminal fine imposed under sec. 7201, I.R.C., and 18 U.S.C. secs. 371, 3622, and 3623 (Supp. II, 1984).

Martin A. Schainbaum and David B. Porter, for petitioners.

Paul J. Krug, for respondent.

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* This Opinion supplements our Memorandum Opinion in Schachter v. Commissioner, T.C. Memo. 1998-260.

SUPPLEMENTAL OPINION

SWIFT, Judge: This matter is before us under Rule 155 on the parties' disputed computations of the decision to be entered herein.

The issue for decision is whether petitioners should be allowed a credit against civil fraud additions to tax for a $250,000 criminal fine imposed on petitioner Martin Schachter (petitioner).

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

On September 23, 1993, petitioner pleaded guilty under section 7201 to one count of income tax evasion and to one count of conspiracy under 18 U.S.C. section 371 (1994) to defraud the United States with respect to his individual Federal income tax liability for 1986. In connection with the above plea, under the authority of 18 U.S.C. sections 3622 and 3623 (Supp. 11, 1984), now repealed and replaced by 18 U.S.C. sections 3572 and 3571 (1994), respectively, a Federal District Court judge sentenced petitioner to serve 2 years in prison, to pay a fine of $250,000 (criminal fine), and to pay restitution to the Internal Revenue Service of $161,845.

After petitioner's criminal conviction and sentencing, respondent determined and we sustained incomel,tax deficiencies and civil fraud additions to tax relating to petitioners' tax years 1985, 1986, 1987, and 1988. See Schachter v. Commissioner, T.C. Memo. 1998-260.

In their respective Rule 155 computations, without application of the claimed credit for the $250,000 criminal fine, the parties agree that petitioners are liable for the following deficiencies and additions to tax:

		Additions to Tax							
Year	Deficiency	Sec. 6653 (a)(1)	Sec. 6653 (a)(1)(A)	Sec. 6653 (a)(1)(B)	Sec. 6653 (b)(1)	Sec. 6653 (b)(1)(A)	Sec. 6653 (b)(1)(B)	Sec. 6653 (b)(2)	Sec. 6661
1985	$163,048	–	–	–	$81,524	–	–	**	$40,762
1986	168,948	–	$ 179	*	–	$120,280	**	–	40,987
1987	109,791	–	662	*	–	72,408	**	–	27,448
1988	21,488	$39	–	–	12,262	–	–	–	5,372

* 50 percent of interest due on portion of underpayment attributable to negligence.

** 50 percent of interest due on portion of underpayment attributable to fraud.

Throughout litigation of this case, petitioners have maintained that imposition of the civil fraud additions to tax on top of petitioner's 2-year prison sentence and the $250,000 criminal fine would constitute double jeopardy and would violate the U.S. Constitution. The Supreme Court, however, has held that Congress may impose both criminal and civil sanctions with regard to the same acts without violating the double jeopardy clause of the U.S. Constitution. See Helvering v. Mitchell, 303 U.S. 391, 399 (1938); see also Hudson v. United States, 522 U.S. 93 (1996); Kennedy v. Mendoza-Martinez, 372 U.S. 144 (1963); Spies v. United States, 317 U.S. 492 (1943); Grimes v. Commissioner, 82 F.3d 286 (9th Cir. 1997), affg. Ward v. Commissioner, T.C. Memo. 1995-286.

In Spies v. United States, supra at 495 (citing Helvering v. Mitchell, supra), in explaining that Congress may impose both criminal and civil sanctions in enforcing the tax laws, the Supreme Court stated that "invocation of one does not exclude resort to the other." See also United States v. Sabourin, 157 F.2d 820, 821 (2d Cir. 1946); and Schwener v. Commissioner, T.C. Memo. 1987-594, for the same proposition.

In light of Helvering v. Mitchell, supra, and the subsequent cases, in Schachter v. Commissioner, supra, we rejected petitioners' double jeopardy argument, and we sustained respondent's determination of the civil fraud additions to tax.

In the current computational dispute, petitioners do not again dispute under the double jeopardy clause of the U.S. Constitution imposition of both criminal and civil sanctions with regard to the same acts. Rather, petitioners argue that the $250,000 criminal fine that was imposed on petitioner should be allowed as a credit against the civil fraud additions to tax for 1985, 1986, 1987, and 1988 that were determined by respondent against petitioner and that were sustained in our prior opinion. Helvering v. Mitchell, supra, and its progeny do not directly address whether taxpayers have a right to credit against civil fraud additions to tax the amount of related criminal fines.

Petitioners' argument is premised on the notion that the $250,000 criminal fine did not constitute punishment, that it served only remedial purposes, and that it should be treated as restitution. Petitioners then appear to argue that, because respondent routinely would reduce outstanding civil income tax deficiencies by the amount of restitution, petitioners should be allowed to reduce the civil fraud additions to tax by the $250,000 criminal fine.

Petitioners also argue that the sentencing factors listed in 18 U.S.C. section 3622, which Federal District Court judges take into account in imposing fines under 18 U.S.C. section 3623, support petitioners' contention that the $250,000 criminal fine imposed on petitioner should be regarded as remedial in nature and as restitution for petitioners' civil fraud additions to tax.

Respondent disagrees with petitioners' characterization of the $250,000 criminal fine as remedial in nature. Respondent argues that Congress enacted 18 U.S.C. section 3623 to provide Federal District Court judges with alternative means to punish criminals and to deter future criminal behavior. Because criminal fines and civil fraud additions to tax serve different congressional purposes, respondent argues that petitioners should not be allowed a credit against the civil fraud additions to tax for petitioner's $250,000 criminal fine. We agree with respondent.

The Supreme Court has described civil fraud additions to tax as established "for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud.," Heivering v. Mitchell, 303 U.S. at 401; see also Louis v. Commissioner, 170 F.3d 1232, 1235 (9th Cir. 1999), affg. T.C. Memo. 1996-257; Thomas v. Commissioner, 62 F.3d 97, 100 (4th Cir. 1995), affg. T.C. Memo. 1994-128; Ames v. Commissioner, 112 T.C. 304 (1999).

In Ianniello v. Commissioner, 98 T.C. 165, 182 (1992), we rejected arguments under the Double Jeopardy Clause of the U.S. Constitution that civil fraud additions to tax should not be imposed on top of criminal forfeitures under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. sections 1961-1968 (1988). We concluded in that case that criminal forfeitures under RICO constitute punishment for

commission of crimes while civil fraud additions to tax constitute remedial penaltie.s. We explained that a --

> fine and term of imprisonment imposed on the taxpayer after conviction for personal income tax evasion is punishment for the commission of a crime, and not reimbursement for costs incurred by the United States in investigating the taxpayer's fraud.

Ianniello v. Commissioner, supra at 183.

Petitioners argue that the decision in Ianniello v. Commissioner, supra, is distinguishable from the instant case because Federal District Court judges have more discretion in imposing criminal fines than in imposing criminal forfeitures. The point, however, is not the degree of discretion a judge has in imposing a criminal fine but whether the purpose of the criminal fine is punishment.

The legislative history of 18 U.S.C. sections 3622 and 3623 indicates that fines imposed under these provisions were intended by Congress to constitute punishment for criminal acts. In 1984, Congress passed the Criminal Fine Enforcement Act of 1984, Pub. L. 98-596, 98 Stat. 3134, in order to encourage the more frequent use of fines as an alternative to, or as an addition to, imprisonment. See H. Rept. 98-906, 1 (1984). Pursuant to section 6(a) of the Criminal Fine Enforcement Act of 1984, 98 Stat. 3136, sections 3622 and 3623 were added to 18 U.S.C. chapter 229 (Fines, Penalties and Forfeitures). Under 18 U.S.C. section 3623, the amount of criminal fines that a judge could impose on individuals or corporations was increased. See H. Rept. 98-906, supra at 15-16. The House report accompanying the Criminal Fine Enforcement Act of 1984 explains that under prior law fines were regarded as too low to deter criminal

conduct, and hence Congress established higher maximum fine levels. H. Rept. 98-906, supra at 16. 11

The increased maximum fine levels under 18 U.S.C. section 3623 were tempered somewhat by 18 U.S.C. section 3622, which required judges, in determining appropriate fines to impose, to consider factors such as a convicted offender's ability to pay and whether restitution was ordered.[1] H. Rept. 98-906, supra at 4, 13-15.

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1 18 U.S.C. sec. 3622 provides as follows:

SEC. 3622. Factors relating to imposition of fines

(a) In determining whether to impose a fine and the amount of a fine, the court shall consider, in addition to other relevant factors-

(1) the nature and circumstances of the offense;

(2) the history and characteristics of the defendant;

(3) the defendant's income, earning capacity, and financial resources;

(4) the burden that the fine will impose upon the defendant, any person who is financially dependent on the defendant, or any other person (including a government) that would be responsible for the welfare of any person financially dependent on the defendant, relative to the burden that alternative punishments would impose;

(5) any pecuniary loss inflicted upon others as a result of the offense;

(6) whether restitution is ordered and the amount of such restitution;

(7) the need to deprive the defendant of illegally obtained gains from the offense;

(8) whether the defendant can pass on to consumers or other persons the expense of the fine; and

(b) If, as a result of a conviction, the defendant has the obligation to make restitution to a victim of the offense, the court shall impose a fine or penalty only to the extent that such fine or penalty will not impair the ability of the defendant to make restitution.

Clearly, however, 18 U.S.C. section 3623 was enacted to encourage judges to impose more fines as punishment, and 18 U.S.C. section 3622 simply provides guidance to judges in deciding whether to impose a fine as punishment, and if a fine is to be imposed, the amount of the fine. The factors listed in 18 U.S.C. section 3622 do not convert the purpose of criminal fines imposed under 18 U.S.C. section 3623 into something other than punishment.

We note that if we were to allow a credit against civil fraud additions to tax for criminal fines, Congress' intent in making taxpayers responsible for a portion of the Government's cost in detecting, investigating, and prosecuting a taxpayer's fraud would be substantially frustrated.

Other arguments made by petitioners have been considered and are without merit. We reject petitioners' claim to a credit against civil fraud additions to tax for the $250,000 criminal fine.

To reflect the foregoing,

Decision will be entered in accordance with respondent's computations.